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1st Session

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MONETARY POLICY REPORT FOR 1989

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

DECEMBER 20, 1989.—Ordered to be printed
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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, December 18, 1989.

Hon. DAN QUAYLE,
President of the United States Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the Monetary Policy Report for 1989 on the conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearings held on February 21, 1989, and August 1, 1989.

Sincerely,

DONALD W. RIEGLE, Jr.,
Chairman.

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Mr. RIEGLE, from the Committee on Banking Housing, and Urban Affairs, submitted the following

REPORT

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ADDITIONAL VIEWS

[Submitted pursuant to Public Law 95-523]

INTRODUCTION

On February 21, 1989, the Committee on Banking, Housing, and Urban Affairs held the first of two monetary policy hearings for 1989 as called for by the Full Employment and Balanced Growth Act of 1978. The Committee received the Federal Reserve's "Monetary Policy Report to Congress" and heard the testimony of its Chairman on the conduct of policy in 1988 and policy objectives for 1989. The second hearing took place on August 1, 1989, when the Committee again heard Alan Greenspan, this time testifying on the conduct of monetary policy in the first half of 1989 and on policy objectives for the remainder of 1989 and for 1990. The associated report was received July 20, 1989.

While the Committee had hoped to be able to schedule additional hearings with other witnesses, work by the Committee on savings and loan legislation made that impossible. Nevertheless, the two hearings, the reports, and other publicly available information provided the Committee with an adequate basis for the Committee's findings and recommendations.

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MONETARY POLICY IN 1988 AND THE FIRST HALF OF 1989

The exchange value of the dollar fell sharply from early 1985 through the end of 1987, providing considerable stimulus to the economy. The Federal Reserve pushed interest rates up gradually until the stock market crash in October 1987. Thereafter, for several months, the Federal Reserve's primary concern was placed on financial market stability and the potential for a post-crash recession. Lower interest rates kept financial markets calm, but did nothing to restrain the inflationary pressures stemming from a boom in exports, aided by the cheaper dollar and soaring import prices. The Federal Reserve moved steadily but cautiously to edge interest rates up, starting in the spring. Adjusted for farm production lost because of severe drought, the economy grew 4 percent during 1988 after growing 5½ percent in 1987. Both increases were well above what the Federal Reserve and most other observers consider a sustainable rate: perhaps 2½ percent. Consumer price inflation, excluding volatile food and energy items, rose from 3.3 percent in 1986 to 4.7 percent by 1988.

At the start of 1989, the economy was still growing strongly, and inflation was accelerating rapidly. The producer price index rose at a double-digit rate in the first 3 months of the year and consumer prices accelerated to a 6 percent annual rate. At the same time, the worsening savings and loan crisis, the rapid buildup of debt throughout the economy (especially at corporations affected by leveraged buyouts and other forms of restructuring), and external debt problems of developing countries made interest rate increases and the threat of recession more risky.

The Federal Reserve chose to attempt a "soft landing." Monetary policy objectives for 1989 presented to the Committee by the Federal Reserve in February were judged by the Federal Open Market Committee to be consistent with only a 2 percent increase in economic production, adjusted for the effects of the 1988 drought (table 1).

So far, this policy has been reasonably successful. Adjusted for the recovery in farm production, economic growth in the first half of 1989 slowed to just about the rate projected by the Federal Reserve. Unemployment did not increase, and consumer price inflation showed dramatically to a 2½ percent annual rate between May and August. Interest rates have begun to recede.

TABLE 1.—FEDERAL RESERVE ECONOMIC PROJECTIONS

[Central tendency]

	1988 actual	1989		1990 July projection
		February projection	July projection	
Percent change, 4th quarter to 4th quarter:				
Nominal GNP	7.5	6½ to 7½	6 to 7	5½ to 6¾
Real GNP [1]	3.4	2½ to 3	2 to 2½	1½ to 2
CPI	4.4	4½ to 5	5 to 5½	4½ to 5
Average level in the 4th quarter: Civilian unemployment rate.	5.3	5¼ to 5½	5½	5½ to 6

[1] Drought reduced growth in 1988 by 0.6 percent and will increase growth in 1989 by a comparable amount.

PROJECTION FOR THE SECOND HALF OF 1989 AND FOR 1990

In its July report, the Federal Reserve presented an even more pessimistic outlook. They lowered the projected growth of GNP in 1989, implying a weak second half of the year, estimated 1990's growth at a similarly low 1½ to 2 percent. Inflation was projected to slow only modestly despite the strengthening dollar, and unemployment to increase by about one-half of a percentage point.

SUMMARY OF TESTIMONY—FEBRUARY

In discussing economic and financial developments in 1988, Chairman Greenspan said that increased interest rates and slower monetary growth had "been a necessary aspect of monetary policy designed to contain inflation and promote price stability and economic growth." The surprising strength of the economy following the stock market crash was accompanied by an acceleration of inflation. He also reported that:

> the federal budget deficit remained high and our national saving low. This contributed to a continued large current account and trade deficit. By keeping pressure on interest rates, the low rate of saving also was a factor behind the performance of business fixed investment last year. Investment slowed from 1987, especially in the second half of the year, even in the face of relatively rapid expansion of production and high levels of capacity utilization.

Describing plans for monetary policy in 1989, he said "the Federal Reserve remains more inclined to act in the direction of restraint than toward stimulus. He stated that the Federal Reserve sought "continued economic expansion while putting in place conditions for a gradual easing in the rate of inflation over time."

Chairman Greenspan testified that, in his view, monetary policy can do little to affect the long-run growth of the economy except foster price stability. He emphasized the importance for growth of better educating our labor force and "stepping up the pace of capital accumulation". He said that increasing saving is important; "Probably the most direct and sure way of increasing saving is by a reduction in government dissaving."

During the question and answer session, Chairman Greenspan responded to questions about differences between the Administration's forecast and the Federal Reserve's by saying that while he thought the Fed's was more probable, a decrease in the deficit as called for in the President's budget would produce lower interest rates.

A large portion of the remaining questions concerned the deficit. Chairman Greenspan reiterated his view that a reduction was critical even if sequestration was the only way to do it. He was hopeful that an agreement between Congress and the President would be reached.

In response to a question about real interest rates, Mr.Greenspan said that while the Fed acted to affect short-term real rates directly, long-term real rates were more important influences on the economy. He claimed that while nominal long-term rates had shown little change over the preceding year, inflation expectations

had come down, so long-term real rates had increased as the Fed raised short-term rates.

SUMMARY OF TESTIMONY—AUGUST

Commenting on developments in the first half of 1989, Chairman Greenspan said that after a further acceleration of inflation, the price outlook had improved. That improvement, coupled with evidence of a softening in the economy, led the Fed to lower short-term interest rates beginning in June. In his estimation, "the balance of risks may have shifted somewhat away from greater inflation. Nevertheless, he said that the Federal Reserve would still seek to reduce inflation further and that "the monetary authorities must face the responsibility for any lasting price trends." He said he sought a delicate balance that would "avoid an unnecessary and destructive recession."

In the question and answer period, Chairman Greenspan was asked how long he intended to hold economic growth below a 2 percent annual rate. He said that it would be for "a good part" of the period through the end of 1990, and that "we will be slow for a period, but that we will pick up at some point."

In response to a question about the effect of the rise in the dollar this year, he said that it had slowed the adjustment process, that improvements in the trade and current account balances would pause but would begin again next year in a significant way. Fundamental adjustments would depend on improvements of our saving-investment imbalance.

There were again a large number of budget-related questions. Chairman Greenspan reiterated his preference for a chronic surplus in the unified budget to increase domestic saving and spur investment but doubted that the will existed to balance the budget indefinitely if social security, including intragovernmental interest payments, were excluded from the budget calculations. Several questions dealt with the proper treatment of funding to resolve the savings and loan crisis. Mr. Greenspan said that he preferred it be off-budget for political rather than economic reasons, that he was afraid of the precedent a Gramm-Rudman waiver would create.

In answer to a question about why Japanese interest rates were lower than ours, Chairman Greenspan said that their higher propensity to save and lower inflation rates were responsible.

FINDINGS AND RECOMMENDATIONS

1. It was appropriate that so much of the discussion in the hearings related to budget issues. The budget deficit is our single most important macroeconomic problem. It molds the environment in which the Fed must work and complicates its task. Our private saving rates are low, by themselves, but dissaving by the government leaves very little to invest in our future.

Table 2 indicates the severity of our saving problem. The past 7½ years from a sharp contrast with preceding 10-year periods. Private saving, even including social security fund increases, as a percent of net national product has fallen from levels already well below those of most other developed countries. But more seriously, the federal budget deficit has jumped up to the point where it now

absorbs more than 60 percent of our private saving. That leaves less than 3 percent of net output available for investment. The recent trend of deficit reduction is not encouraging. Reported budget deficits have remained steady the past 3 years but excluding social security, which was redesigned in 1983 to be a separate source of earnings for enormous future retirement needs, the deficit is getting worse.

TABLE 2.—SOURCES OF DOMESTIC SAVING

[In percent, as a share of net national product]

	Private saving (plus Social Security)	Government savings (excluding Social Security)	Net domestic saving
1952–61	8.15	−0.65	7.50
1962–71	9.15	−.86	8.29
1971–81	9.64	−2.00	7.64
1982–82Q2	7.98	−5.14	2.84

The impact of this savings shortfall on our future is suggested by the data in table 3. Buoyed by foreign capital inflows, domestic investiment spending has declined less sharply than domestic saving, but business fixed investment has suffered disproportionately. Capital spending is critical for gains in productivity. Capital per worker in non-farm business increased just 2 percent from 1981 to 1988. It increased 2 percent per year during the previous 30 years. Given this record, it is not surprising that productivity increases have been unsatisfactory. Other factors contribute to poor productivity growth; public works or "infrastructure" spending is lower than a quarter century ago (while the economy has more than doubled in size), and deteriorating quality of education is indicated by the drops in test scores of students.

TABLE 3.—NET INVESTMENT

[In percent, as a share of net national product]

	Net foreign investment	Net domestic investment	Net business fixed investment	Net business fixed investment less one-third of net foreign investment
1952–61	−0.34	7.34	3.14	3.25
1962–71	−.59	7.65	3.70	3.90
1972–81	−.30	7.34	3.65	3.75
1982–88	2.55	5.00	2.16	1.31

Because we have funded our meager investment spending with foreign capital, our income growth is further depressed. Capital from any source increases productivity and worker wages. But when foreigners have supplied the capital, earnings on that capital go to foreigners. The right-hand column of table 3 shows an adjusted measure of capital formation. Assuming that one-third of the benefits of new capital are captured by the owners of capital, it

shows how much business investment would be needed, in the absence of foreign capital flows, to have the same effect on domestic income growth as the combined effect of actual investment and actual foreign capital inflows.

Income growth in the 1980s has been supported by abnormal increases in the portion of the population with jobs. That trend cannot be expected to continue. Baby boomers have all matured to working age, our elderly population is growing rapidly, the shift of women to higher participation rates is nearing completion, and the return of unemployment rates to historically normal levels from the high rates of the early 1980s is finished. If our overall national savings rate, private and especially public, does not improve, the trend in income growth will be much slower in the coming years.

2. The Federal Reserve Act directs the Federal Reserve to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." That is as it should be. The Committee disagrees with recent suggestions to give the Fed responsibility for inflation and nothing else. Although the goals specified in the Act are mutually consistent in the long-run, short-run conflicts may exist which should not be resolved arbitrarily. Policies designed to achieve one of those goals in a set period of time in neglect of the other goals would be inappropriate.

The Fed's task is to keep inflation low while reducing macroeconomic fluctuations to a minimum. Output lost in a severe recession stemming from single minded pursuit of an overly rapid reduction in inflation may never be fully recovered. Similarly, efforts to force the economy to expand beyond its capacity may push inflation to intolerable heights and lead to long-term inefficiencies more than offsetting the temporary gains in production. Since 1982, the Federal Reserve has been very successful in steering this middle course.

3. Short-term political pressures to adopt a deviant path can sometimes be powerful. Accordingly, a suitable degree of independence for the Federal Reserve is essential. The Committee believes the Fed's current structure appropriately provides some insulation from these pressures, while insuring longer term accountability. Such independence is especially important in an environment where the trend in income growth, because of misguided fiscal policies and demographic changes, is less than what we have achieved in the past and what some would seek to achieve in the future.

A reduced trend in income makes the Fed's job tougher. Chairman Greenspan said in his August testimony, "I cannot rule out a policy mistake as the trigger for a downturn." Sudden unexpected changes in economic behavior or external shocks can have a similar effect. The closer our trend growth is to zero, the greater the likelihood that a mistake or shock to the system will have recessionary consequences. A policy designed to avoid recession at all costs, or to maintain growth rates at historical averages is more likely to produce accelerating inflation. At the same time, a policy designed to reduce inflation at all costs, might, given the unprecedented overleveraging in many sectors of our economy, produce a dangerous recession. In such circumstances, the Fed's independence is all the more important.

4. The Federal Reserve's description of its annual objectives in terms of money growth rates, while in compliance with existing statutes, is insufficient to allow informed judgement of the suitability of its plans. The money growth ranges are wide enough to permit policies with extermely different economic implications. Even if they were made narrower, or a single target rate were specified, an evaluation of its reasonableness would be impossible without knowledge of the Fed's implicit interest rate assumptions, which the Fed properly does not reveal.

A simple statement of intermediate and longer-term strategic goals and their justification would be extremely helpful, and the Committee requests that such a statement be provided in future reports or accompanying testimony. The economic projections of the Federal Open Market Committee do contain useful indirect information. They presumably show what the FOMC members believe is the best result attainable, given the range of mounting policy options. In February, inflation was projected to increase in 1989 from 1988, and growth was projected to slow (adjusted for drought effects). Chairman Greenspan testified that he sought "continued economic expansion, while putting in place conditions for a gradual easing in the rate of inflation over time. In response to a written question, he wrote that his aim was to reduce inflation to "a number approximating zero," "within several years." While these statements are suggestive, they fail to convey how the Fed planned to achieve its longer run goal of zero inflation, its estimate of the short-term costs and long-term gains, what the alternatives were, or what circumstances would dictate a change in approach.

The July report showed a 1990 growth projection slower than the 1989 projection (adjusted for the drought) presented in February. But in testimony, the Fed's Chairman said he thought the risks had shifted away from inflation and toward recession. In response to a question he said growth "will be slow for a period, but . . . we will pick up at some point." It was not clear whether the pick up would occur only after the Fed had eliminated inflation or before. If before, how did the Fed plan to eliminate inflation?

5. In addition to a clearer statement of strategic goals, the Federal Reserve could improve its discussion of recent economic developments by including an analysis of real long-term interest rates and indicators of the thrust of monetary policy such as the Fed's new measure of equilibrium prices. Chairman Greenspan indicated the critical importance of real interest rate movements to the effectiveness of monetary policy at the February hearing, and supplied data in response to a written question. That discussion and the data were very helpful, and future reports should give more attention to the behavior of real interest rates. Similary, Chairman Greenspan's February testimony introduced a new inflation indicator, called "P*", which is an equilibrium price series based on movements in M2. It appeared useful in evaluating the implications of past policy actions, and future reports or testimony should include such a measure, as long as it remains informative.

6. Despite the paucity of information in this year's reports about the Federal Reserve's intent and strategy, enough information is available to form a rough judgement of the Federal Reserve's plans for the coming year. It appears the Fed is willing to increase mod-

estly the risk of recession by attempting to hold economic growth slightly below its potential in order to achieve modest reductions in inflation. That does not appear to be an unreasonable approach. It is assumed that the Fed will respond quickly to signs that the economy is veering into recession or that the overly rapid growth of 1987 and 1988 is being repeated.

7. The increase in the exchange value of the dollar so far this year of roughly 5 to 10 percent is troubling in that it makes progress toward balance in our external accounts even more difficult. We have seen in the middle years of this decade how destructive an overvalued currency can be to many of our critical manufacturing industries. Adjustments in the domestic policies of other countries helped considerably to bring exchange rates into a more sustainable framework. At this point, the key change needed is in our own economy. Lower budget deficits and higher savings rates would reduce the need for foreign capital and, by allowing lower interest rates, diminish the incentive of foreign investors to acquire dollars for investment in the United States. The resulting decline in the dollar would do much to make our industries more competitive abroad. More progress, however, must also be made in getting countries with large trade surpluses to open their markets and reduce trade restrictions, both explicit and implicit, to American goods.

ADDITIONAL VIEWS OF SENATOR JIM SASSER ON THE MONETARY POLICY REPORT FOR 1989

I agree with much of the analysis presented in the Committee Report as to the Federal Reserve's conduct of monetary policy in 1989, but wish to comment on several of the Committee's conclusions. In particular, I am not as confident that the Federal Reserve has chosen the proper course regarding interest rates in view of developments in the economy. Although the Federal Reserve has eased credit modestly as of late, it has been too slow in doing so, and not nearly aggressive enough. Indeed, I think that there is increasing evidence that we may be sliding into recession. If this is so, it will be the result of the Fed's tightening of monetary controls that occurred from approximately the Spring of 1988 until the Spring of this year.

A review of recent data illustrates an economic slowdown in process. Manufacturing employment has declined for 9 straight months. Since March of 1989, 164,000 manufacturing jobs have been lost. In November alone, 27,000 jobs were eliminated. The auto industry has been particularly hard hit; car sales are down 4.5 percent so far this year, with continued production cuts and layoffs expected. Unemployment in the major industrial States has jumped dramatically, and jobless claims nationwide are now 21 percent above last year at this time. According to the National Association of Purchasing Management's 38th semiannual economic forecast, purchasers are expressing more concern about the next 12 months than at any time in the past 27 years.

In the last year, corporate profits have fallen precipitously; third quater 1989 profits are well below levels of a year ago. With profits down, fully 30 percent of nonfinancial corporate cashflow must be dedicated to fund interest payments. In the manufacturing sector, the 25 percent interest/cash flow ratio is far above the 18 percent ratio that characterized the 1981–82 recession. In the financial sector, there are problems in the junk bond market, as well as the potential for problems with commercial banks that are overburdened with leveraged buyout lending and nonperforming loans to lesser developed countries.

Given all of the above, I think it is simply premature to applaud the Federal Reserve's tight money policy and goal of a "soft landing" for the economy. Indeed, the data is indicating that the Fed may have failed. Certainly, the economy's recent performance demands an earnest easing of rates by the Federal Reserve in the very near future.

Moreover, it isn't entirely clear that the Fed's anti-inflation course of the past 2 years has been justified. In fact, I disagree with the report's contention that the Fed acted belatedly in pushing up rates in 1988, and that "inflation was accelerating rapidly" at the start of 1989. There has been nothing reticent about the Fed's in-

flation fight. Between March 1988 and March 1989, the Federal funds rate soared 3.27 percentage points. This was accomplished by a dramatic draining of reserves from the banking system. In the third and fourth quarters of 1988, aggregate reserves actually declined at an annual rate of 2.4 and 3.2 percent respectively.

Importantly, over the same period, inflation was concentrated only in certain sectors, primarily energy and food, but not in others. Moreover, there was not strong evidence of a wage/price spiral—the historic driving force behind structural inflation. Indeed, overall the recent data on inflation shows a clear decline.

In short, I do not believe that the growth of inflation in the economy has been significant enough to justify the tightness of the monetary policy that the Federal Reserve has followed up until recently. Nor do I believe that the relaxation of credit that has occurred over just the past few months has been meaningful enough, particularly in view of the present signs of weakness in the economy.

Turning to certain legislative proposals regarding the Federal Reserve, I wholeheartedly agree with the Committee that we should not give the agency responsibility for fighting inflation to the exclusion of everything else. In particular, it would be unwise to charge the Federal Reserve with eliminating inflation over a set period of time. Princeton University economist Alan Blinder estimates that shaving one percentage point off inflation requires an increase of one percentage point in the unemployment rate for 2 years. Therefore, just cutting the inflation rate to 2 percent would mean throwing 2 million Americans out of work for 2 years.

As for the structure of the Federal Reserve, I agree that a "suitable" degree of independence is essential. However, contrary to the Committee, I am not entirely sure that its current structure provides the proper insulation from outside pressures. Indeed, several legal scholars, economists and members of Congress, have argued over the years that the composition of the Federal Open Market Committee could be unconstitutional and subject to outside pressures, since certain members are neither appointed by the President nor confirmed by the Senate—they are rather representatives of the private banking industry.

Last, I agree with the Committee's concern about the Federal budget deficit, and its relation to the nation's enormous trade deficit. However, I believe the Committee overlooks the degree to which monetary policy can directly affect the trade balance by affecting the value of the dollar. To a certain extent the decline of our export competitiveness can be traced to the extraordinarily inflated value of the dollar in the early 1980's—a situation that was more a function of interest rates at that time than it was our fiscal imbalance.

JIM SASSER.

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